

# **The Elements of an Investor Protection Fund in Egypt**

**The Egypt Capital Markets Development Project**

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## ACRONYMS

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CASE	Cairo and Alexandria Stock Exchanges
CBE	Central Bank of Egypt
CIPF	Canadian Investor Protection Fund
CMA	Capital Market Authority
CMD	Capital Markets Development project
ECMA	Egyptian Capital Market Association
EIMA	Egyptian Investment Management Association
ICS	Investor Protection Compensation Scheme (U.K.)
IPF or the "Fund"	Egyptian Securities Investor Protection Fund
MOEFT	Ministry of Economy and Foreign Trade
MOF	Ministry of Finance
MCSD	Misr for Clearing, Settlement, and Depository
SEC	Securities and Exchange Commission (U.S.)
SIPA	Securities Investor Protection Act (U.S.)
SIPC	Securities Investor Protection Fund (U.S.)
SRO	Self-regulatory organization
USAID	United States Agency for International Development



## **EXECUTIVE SUMMARY**

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In this report, the Egypt Capital Markets Development (CMD) project recommends the essential elements of an Egyptian fund to insure securities investors against loss of cash and securities caused by the insolvency or bankruptcy of a securities intermediation company. The report was prepared with the assistance of Morris Simkin from CMD's U.S.-based legal subcontractor Winston & Strawn. Mr. Simkin, an experienced and former U.S. Securities and Exchange Commission (SEC) lawyer, was involved in the creation of the U.S. Securities Investor Protection Corporation (SIPC).

For the purpose of comparison, the report is accompanied by appendices summarizing the main features of SIPC, the U.K. Investors Compensation Scheme (ICS), and the Canadian Investor Protection Fund (CIPF).

### **Name of the Fund**

This report refers to the fund as the "Investor Protection Fund" or IPF.

### **Organization and Administration of the Fund**

The fund, to be established by a decree of the Prime Minister, should be a separate entity regulated by the Capital Market Authority (CMA). The Prime Minister should appoint the IPF's chairman and board of directors, members of which should represent the CMA, the Ministry of Economy and Foreign Trade (MOEFT), the Central Bank of Egypt (CBE), the Cairo and Alexandria Stock Exchanges (CASE), the Egyptian Capital Market Association (ECMA), and members of the public.

The staff of the fund should comprise a chief executive officer, chief financial officer, and chief legal officer. These officers may work on a part- or full-time basis, depending on the volume of the IPF's operations. The size of the staff will depend on the regulatory and enforcement powers the fund is given (see next two sections). At a minimum, the staff will collect, invest, account for, and disburse the IPF's moneys. It will also monitor and oversee the activities of outside attorneys and accountants who are appointed to represent the IPF in bankruptcy court liquidations.

### **Regulation**

The IPF should have regulatory and enforcement powers with respect to the collection, investment, and disbursement of its moneys. In addition, the CMA—in coordination with one or more of Misr for Clearing, Settlement, and Depository (MCSD), CASE, and ECMA—should establish a comprehensive record-keeping, financial responsibility, and customer protection regulatory scheme. Establishing such a scheme will impose costs on securities intermediation companies but will likely reduce the cost of the IPF. This scheme should cover the following areas:

- Maintenance of books and records
- Maintenance of errors and omissions insurance
- Maintenance of fidelity bonds to cover losses from fraud
- Segregation of customer monies and securities from those of securities intermediaries
- Requirements for periodic reporting to the regulator and to customers

- Requirements for paid-in and net capital

In addition to rules in these areas—and as part of an effective system so that the IPF can readily pay customers of insolvent securities intermediation companies—securities intermediaries should be required to render periodic (e.g., monthly, quarterly, and annual) statements to their customers. These reports would set forth the funds and securities of the customer under the possession or control of the securities intermediation companies. If one of the intermediaries goes bankrupt, the customers should be able to furnish the IPF with copies of their last account statement as the initial basis for their claims.

## **Enforcement**

Depending on policy decisions made by the CMA, the IPF will need regulatory and enforcement authority. It should have the authority to suspend the conduct of business by a participant that fails to pay its assessments. If the IPF is given authority to adopt some or all of the rules set forth above (under “Regulation”), it will also need the authority to inspect securities intermediation companies to ensure compliance with these rules and take enforcement action against non-complying companies. If, on the other hand, rule-making and enforcement authority in these areas is vested in the CMA or another market institution (functioning as a self-regulatory organization), the IPF should be given the right to assure the financial and operational responsibility of securities intermediation companies. For example, it should have the right to participate in examinations of securities intermediaries, be given copies of inspection reports and reports filed with market institutions and the CMA, and be granted the authority to take enforcement action against intermediaries that violate rules covering financial and operational responsibility. Market institutions should also coordinate their rule-writing, inspection, and enforcement activities with and through the IPF.

## **Oversight**

The IPF’s ability to write rules and determine assessments on securities intermediation companies should be subject to CMA approval. The CMA should also have the right to require the IPF to amend or delete rules it determines are inappropriate or no longer serve the purposes intended, and to adopt or amend rules as needed to respond to new developments. To perform this role, the CMA should have the right to inspect the IPF and take appropriate action if the IPF fails to discharge its responsibilities or is not doing it in the desired manner.

## **Protection Afforded by the Fund**

The fund will protect investors against losses of cash and securities arising from the insolvency or bankruptcy of a securities intermediation company. The IPF should not, unlike the fund in the U.K., cover broker frauds (unless those frauds are the cause of the insolvency or bankruptcy).

The CMA should determine the average value of securities and funds belonging to investors held by or under the control of securities intermediation companies. This proposal recommends that the maximum amount of coverage should be set in Egyptian pounds so as to cover 90 percent of customers’ accounts in full. The compensation to investors should not make any distinction between cash and securities.

## **Payments**

The fund will pay the customers of an insolvent or bankrupt securities intermediary company immediately after acceptance of the claims by the IPF's board of directors and assignment of the customer's claim to the IPF. After payment to the customers, the IPF, as assignee of the customer's claims against the insolvent or bankrupt participant, will pursue those claims in bankruptcy court proceedings to recover the compensation paid and other allowable costs.

## **Funding**

Primary funding for the IPF should come from periodic assessments on securities intermediation companies—at a percentage based on their securities industry income—until the IPF reaches a level where interest on its investments is sufficient to support its annual operating budget and claims.

The IPF should have access to two other sources of funding to enable it to deal successfully with situations where liquidity requirements exceed or otherwise create a negative cash flow, particularly before it reaches the appropriate funding level. First, the IPF should be authorized to establish lines of credit with Egyptian banks up to a specified level. In the event that such lines of credit are utilized, the IPF must be able to levy a second assessment on securities intermediaries to repay the draws on the line of credit over a two- to three-year period. Second, the IPF should also be able to borrow from the Egyptian treasury, which may require enabling legislation. To borrow from the treasury, the fund should be required to obtain CMA approval, showing reasonable grounds for such borrowing and a plan for its repayment.





## **THE EGYPTIAN SECURITIES INVESTOR PROTECTION FUND (IPF)**

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Set forth herein is a proposed vehicle to insure Egyptian investors against loss resulting from the insolvency or bankruptcy of a securities intermediation company that has possession or control of an investor's funds or securities. These intermediaries would be participants in the Investor Protection Fund (IPF), and their customers would be protected against the losses covered by the IPF.

### **A. Structure**

The IPF, to be established by a decree of the Prime Minister, should be a separate entity regulated by the Capital Market Authority (CMA). The Prime Minister should appoint the IPF's chairman and its board of directors. Aside from the chairman, who will be selected by the Prime Minister, the board members should represent the following:

- One member nominated by the CMA, who is not a member or employee of the CMA
- One member nominated by the Ministry of Economy and Foreign Trade (MOEFT)
- One member nominated by the Central Bank of Egypt (CBE)
- One member nominated by the Cairo and Alexandria Stock Exchanges (CASE)
- Two members nominated by the Egyptian Capital Market Association (ECMA)
- Two members, selected by the Prime Minister, representing the investing public and who are not employed by a participant, receive a material portion of their revenue from a participant, or are dependent upon a person who receives a material portion of their income from a participant.

The IPF will need a staff or permanent secretariat. The size of the staff will depend on the functions and responsibilities assigned to the IPF by the CMA. We propose the following three functions:

1. The IPF would oversee the collection and administration of funds used to pay for liquidations as well as the operating budget of the IPF;
2. The IPF would have regulatory and enforcement authority in one or more areas (these are discussed below). It would need sufficient staff to discharge these responsibilities; and
3. The IPF would monitor and oversee the activities of its staff as well as outside attorneys and accountants it has appointed to represent it in the bankruptcy court liquidations of a participating firm.

The base staffing would involve a chief executive, a chief financial officer, and a chief legal officer with sufficient support staff. The executive staffing may be on a full- or part-time basis, depending on the demands of the IPF's operations. The non-executive staff could constitute the permanent secretariat acting on the direction and supervision of the executive staff.

Another factor that will influence the size of the IPF is the caseload of insolvent participants that it will be overseeing. The CMA may have historical data as to failed securities intermediation companies. This would be useful in making this assessment, although preliminary assessments indicate that there have been no such failures. By way of comparison, SIPC in the U.S. handled some 247 liquidations in the period 1973 to 1999. The ICS in the U.K. handled some 726 insolvencies during the period 1988 to 1999. This larger number may be due to the fact that the ICS also insures against loss due to certain frauds, while SIPC only covers losses due to insolvency. The recommendations contained herein are to cover only losses due to insolvency or bankruptcy, and not those due to fraud.

## **B. Regulatory Issues**

The CMA—or in coordination with one or more of MCSD, the Cairo and Alexandria Stock Exchange (CASE), and the Egyptian Capital Market Association (ECMA)—should establish a comprehensive record-keeping, financial responsibility, and customer protection regulatory scheme. Establishing such a scheme would impose costs on securities intermediation companies but would likely reduce the costs of the IPF. The U.S., Canada, and the U.K. have established such regulatory schemes.

A comprehensive record-keeping, financial responsibility, and customer protection regulatory scheme would include rules covering the following areas:

1. A requirement to maintain an errors and omissions insurance policy to cover losses due to a participant's inadvertent errors or omissions;
2. A requirement that participants maintain a minimum amount of a fidelity bond to cover losses from the defalcation by a participant's employees;
3. A rule requiring that a participant must deposit customer monies in a bank account segregated from the participant's bank account and that the account be identified as belonging only to customers of the participant;
4. A rule requiring that a participant must at all times keep custody and control over customers' securities segregated from those of the participant, and that the records of the participant must clearly identify the securities positions of customers and the location of such securities;
5. A rule specifying in reasonable detail the books and records a participant must maintain, in a current and accurate manner, and the period of retention of books, records, and documents created by or received by a participant from third parties as part of the participant's securities business;

6. A rule requiring each participant to have financial statements that are audited, at least annually, by an independent certified public accountant, and filed with the participant's self-regulatory organization (SROs)\* and the IPF;
7. A rule requiring each participant to furnish its customers with summaries of the participant's audited financial statement and a semi-annual unaudited financial statement and monthly, quarterly, and annual statements of a customer's account;
8. A rule comparable to the recently adopted Bond Dealer Capital Rule requiring participants to have minimum stated capital which has been paid in;
9. A net capital rule requiring participants to maintain liquid net worth equal to a specified percentage of the participant's exposure to other securities intermediation companies and to its customers; and
10. A sophisticated "early warning" monitoring and response system. This would require participants to submit reports of their financial condition and operational condition when the participant approaches certain trigger points that could raise concern as to the ability of the participant to survive as an ongoing entity. There would be several checkpoints as part of the early warning system. As a participant passes a checkpoint, additional limitations would be imposed on its business until the point was reached where either all of its customers and their assets were removed from the participant's control or the participant was placed in bankruptcy proceedings.

Many of the rules outlined above currently exist in various forms or are authorized under the Capital Markets Law and the Executive Regulations thereunder. Therefore, it may not take extensive action on the part of the CMA, MCSD, CASE, and ECMA to draft and adopt these rules.

But regardless of the number and scope of rules that may be written, without an effective enforcement system, they would be of little value. So meaningful enforcement staffing by the CMA, IPF, CASE, ECMA, or a combination of two or more is essential.

Under such rules and as part of an effective system so that IPF can readily pay off customers of its insolvent participants, the participants should be required to render periodic (e.g., monthly, quarterly, and annual) statements to their customers. These reports would set forth the funds and securities of the customer under the possession or control of the participant. If a participant becomes insolvent or bankrupt, the customers will be able to furnish the IPF copies of their last account statement as the initial basis for their claims to be paid by the IPF.

If a participant becomes insolvent or bankrupt, one or more of the CMA, IPF, CASE, ECMA, or MCSD would lead or cooperate in its authority to examine and inspect the participant's books

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\* CMD anticipates, based on CMA statements, that CASE, MCSD, and ECMA will eventually become SROs, and therefore, we refer to these institutions collectively as SROs in this report.

and records. This would include the last account statements rendered to customers and reconciled from the date of the last statement to the date of insolvency to reflect trades settled since the last statement date. The inspection would verify the correctness of the cash and securities positions of customers to be paid by IPF. As a result of this examination, IPF would determine the amount each customer of the insolvent participant was entitled to receive and would so notify the customers. Customers who disagree with IPF's determination would have a right of appeal to the CMA.

### **C. Enforcement Authority**

As noted above, a meaningful regulatory system requires a meaningful enforcement program. The IPF needs regulatory or oversight authority. IPF should have the authority to suspend the conduct of business by a participant that fails to pay its assessments. In addition, so that they do not look upon IPF as a source of temporary working capital, participants who fail to pay their assessments in a timely manner should be penalized a sufficient amount to discourage such delays.

IPF may be given authority to adopt some or all of the rules set forth above subject to CMA approval as its regulator. If so, IPF will need the authority to inspect participants to ensure compliance with these rules and to take enforcement action against those that do not comply. If rule-making and enforcement authority for the suggested rules is vested in an SRO or the CMA, it would be appropriate to give IPF rights to assure the financial and operational responsibility of its participants. This could be done in one or more of the following ways:

- (a) allow the IPF staff to participate in examinations of participants by these other bodies, either in all examinations or in examinations of participants known to be experiencing difficulties;
- (b) give IPF the right to receive copies of reports of inspections as well as copies of all reports filed by a participant with its SRO;
- (c) give IPF the right to take enforcement action against a participant that violates any of the financial and operational responsibility rules;
- (d) require the self-regulatory authorities to notify and coordinate their rule-writing, inspection, and enforcement activities with and through the IPF; and
- (e) require the self-regulatory authorities to report to the IPF on how their rules are responsive to the requirements of the IPF and how their inspection, examination, and enforcement programs satisfy the IPF's goal to protect investors' funds and securities.

## **D. IPF Oversight**

In every country with an IPF, there is some oversight of the fund's operations and information dissemination. This is so that the investing public is aware of and comfortable that their investments are protected from loss due to the insolvency or bankruptcy of the financial intermediaries holding their assets. Toward this end, the IPF's ability to write rules and determine assessments upon participants should be subject to CMA approval. Also, the CMA should have the right to require the IPF to adopt, amend, or delete rules the CMA determines are appropriate or no longer serve the purposes intended.

The CMA should have the right to: (a) inspect the IPF and the entity of which it is a part; and (b) take appropriate action if the IPF fails to discharge its responsibilities or is doing so in less than the desired manner. Among the actions that could be taken would be to recommend the removal of IPF officials to the Prime Minister, publish a report of the CMA's inspection and the conclusions drawn, and order the IPF to take the corrective action desired by the CMA.

The IPF should be required to publish an annual report of its activities. Included in this report should be a financial statement audited by an independent public accounting firm.

## **E. Protection Afforded by the IPF**

The IPF would protect the customers of its participants from loss due to the insolvency or bankruptcy of the IPF participants who have possession or control over investor funds or securities. Neither SIPC, IPS, or CIPF cover losses due to the insolvency of securities depositories or transfer agents. However, in the U.S., U.K., and Canada it is customary for brokers, which are covered by these insurance plans, to hold the funds and securities of their customers. This is not the case in Egypt. In Egypt, brokers hold customer money or securities from the time when a trade is executed until settlement and at all times in the case of customers who have given their broker discretionary authority over their accounts. The IPF should also include portfolio management companies because many of them have custody or control over their clients' assets.

All the existing IPFs have limits on the amount covered. These limits are of varying amounts. In the case of the IPF, we would suggest that the CMA determine what is the average amount of securities and funds of a customer held by or under the control of a broker and a portfolio management company. We would suggest that the limit of IPF coverage then be set so as to cover 90 percent of accounts in full. We appreciate that this may not provide full coverage for everyone. At the same time there is a need for limits on the aggregate amount of losses the IPF would cover. With the requirement that participants make periodic reports of their financial condition to customers, this limit on IPF coverage would provide an incentive to exercise some element of watchfulness on the part of customers over the custodians of their assets.

Customers would be covered by the IPF for any loss of money and securities held by or under the control of an insolvent participant of the IPF. The IPF would not cover customers' assets other than cash and securities held by an insolvent participant. For coverage purposes, only one account in any one capacity would be covered. Therefore, a customer with two or more general accounts

could not have double coverage, while a customer with a general account and an account in joint ownership with another independent party would have two accounts subject to IPF coverage.

Several other IPFs set separate limits as to the amount of cash and the amount of securities that are covered. In the case of the IPF, we suggest that one limit be set to cover both cash and securities, without distinction. For purposes of valuing the securities being covered, we suggest that they be valued at their market value on the date of insolvency of the participant.

## **F. IPF Payoffs**

Because of the manner in which the IPF is being established, it may not be practical to coordinate its activities with the administration of the bankruptcy of an insolvent participant. Therefore, we propose the following for paying customers of an insolvent participant out of the IPF fund. Upon the filing for bankruptcy by a participant, IPF would notify the customers of that participant as shown on the participant's books. Each customer would have a reasonable period of time within which to respond and make demands for reimbursement of the money and securities held by the insolvent participant for that customer. Proof of such holdings could be provided by furnishing copies of the most recent account statement from the participant, together with any addendum needed to correct errors or to bring the statement up to date. In addition, the IPF or another regulatory authority would inspect the insolvent participant to confirm the amount of monies and securities to which each customer is entitled. If there is a dispute between a customer and the IPF as to whether an account is covered or the contents of the account, a dissatisfied customer could appeal the IPF's decision to the CMA for final resolution.

The IPF would pay each customer up to the maximum amount allowed, but only if the customer assigned its rights against the insolvent participant to the IPF. The IPF, as the assignee of the customers of the insolvent participant, would be a creditor entitled to participate in the participant's insolvency proceeding and to recover on the assigned claims. In this regard, the IPF would need to hire attorneys and accountants to prosecute its claims in the insolvency proceeding. An issue is raised if a customer assigns all its claims against the insolvent participant and the IPF recovers more than the amount paid to that customer. For example, the customer may have claims on contracts as well as in tort against the insolvent and its principals. If the IPF successfully prosecutes them, who should get the excess? Should it be the IPF because it promptly paid the customer and bore the risk and cost of the litigation, or should it be the customer, whose loss was successfully recovered by the IPF?

This early payment of customer claims by the IPF would be advantageous to customers. Customers would receive their money much sooner than the bankruptcy payment would occur. On the other hand, it creates a substantial cash drain on the IPF. The IPF must pay money up front and wait until the liquidation is completed to recover at least some of the money.

## G. IPF Funding

The funding of the IPF payoff of customers and the operating budget of the IPF will come from the securities intermediation companies. All securities intermediaries that have possession or control over investor funds or securities will be required to participate in the fund. There should be three levels of funding.

The first level would be a periodic assessment on the securities intermediation companies. In the U.S., the SIPC assessment is up to 0.5 percent of a participant's income from the securities business until the SIPC fund reaches US\$150,000,000. At that point, the assessment drops to an amount determined by SIPC as sufficient to fund its operations for the coming year. We would suggest a similar structure for the IPF. Securities intermediation companies would be assessed an annual amount equal to a modest percentage of their securities industry income until the IPF reaches a level where interest on its investments (discussed below) is sufficient to fund its annual operating budget. When the IPF reaches that level, the annual assessment would drop to a *de minimus* amount.

As the IPF accumulates money, it would invest the funds in Egyptian government bills and bonds which mature in two years or less. The income on these investments should be tax exempt.

The second level is to deal with the situation where a liquidation may exceed the amount of the IPF or otherwise create a negative cash flow for the IPF. The IPF would be authorized to establish lines of credit with Egyptian banks up to a specified level as determined by the IPF and the CMA. These lines could be drawn on at any time. To repay the draws, the IPF would levy a second assessment on the participants sufficient to repay the draws within a two- to three-year period. The IPF would be authorized, but not required, to pledge money from future assessments to repay these draws.

As a third level of funding, the IPF should be authorized to borrow from the Egyptian treasury. This may require enabling legislation. The IPF would have to obtain CMA approval to do so. CMA approval would be conditioned on the IPF showing reasonable grounds for such borrowing and a plan for its repayment. The repayment could be through a third level of assessments on participants or a fee IPF would charge on all securities transactions effected in Egypt or a combination of the two. If there was an IPF borrowing from the government that the CMA determines could not be repaid within one year without imposing an undue burden on the IPF participants, customers buying or selling securities would pay a special fee (in the U.S. if SIPC borrows from the US Treasury this fee is 1/50 of a percent) based on the gross purchase price or selling price.

Participants would be obligated to pay their several assessments in a timely manner. Participants would have a 30-day grace period within which to pay. After expiration of the grace period, participants would have an additional 60 days within which to pay the assessment plus a penalty and interest. The penalty would be at a level sufficiently in excess of the interest rate at which a participant could borrow money from a third party. If the assessment, interest, and penalty are not paid within 90 days of the date of assessment, the participant's license will be revoked, and it must immediately liquidate. If a participant disagrees with an assessment, it would have to pay the



assessment in full within the 30-day grace period and appeal to the board of directors of the IPF for return of the excess amount plus interest thereon. If a participant feels the late payment penalty is unfair or there is good reason not to assess it, it may request that the IPF waive all or part of the penalty. The IPF may, for good cause, grant the request in whole or in part. However, the interest portion for a late payment may not be waived.

## **H. IPF Recoveries**

The IPF should participate in the distribution of the bankruptcy proceedings of its insolvent participants. The IPF would be the assignee of the claims of the customers of the insolvent participants and would receive the proportionate amount of the pay out from the bankruptcy that those customers would otherwise have received. The IPF would be charged with recovering the amounts it has paid to customers of an insolvent participant, whether from the bankruptcy proceeds of that participant or from third parties.

IPF recoveries from the bankruptcy proceeds of an insolvent participant would be paid into the fund. The proceeds would be applied in the following order until fully consumed.

1. Repay any borrowing from the Egyptian government;
2. Repay draws under the lines of credit; and
3. Deposit into the IPF for future operating expenses and costs of liquidation.

## **I. Use of IPF Fund**

The IPF Fund would consist of the monies on hand, investments in Egyptian government bonds, and the amount the IPF may draw on under its outstanding line of credit. These monies would be used as follows:

1. Pay the claims of customers of insolvent participants;
2. Pay the costs of attorneys and accountants so that IPF can participate in the bankruptcy proceedings of insolvent participants; and
3. Pay IPF's operating costs, such as personnel, office equipment, supplies and services, so IPF can discharge its responsibilities.

## **J. CMA Authority over Principals of Insolvent Participants**

The ministerial decree establishing the IPF or the Executive Regulations should grant the CMA the authority to bar from association with other securities intermediation companies principals of a participant where the IPF has to pay customers of that participant. The principals would include all officers, key employees, directors, and holders of 15 percent or more of the equity of such participants. The decree or the Executive Regulations should also prohibit an insolvent participant from engaging in business.

## **APPENDIX A**

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### **The U.S. Securities Investor Protection Act and Securities Investor Protection Corporation**

The Securities Investor Protection Corporation (SIPC) was created by the Securities Investor Protection Act of 1970 (15 U.S.C. § 78 aaa et seq., as amended) (SIPA) to protect customers of SEC-registered securities broker-dealers.

If a participant broker-dealer can no longer meet its financial obligations, SIPC may ask a federal court to appoint a trustee to liquidate the firm to protect its customers, or, in certain cases, SIPC may protect the customers directly.

The following is an outline of the rules relating to SIPC, as stated in the SIPA.

#### **A. The Securities Investor Protection Corporation (SIPC)**

##### **A1. Creation and Membership of SIPC**

SIPC is a nonprofit corporation and has all the powers conferred upon a nonprofit corporation by the District of Columbia Nonprofit Corporation Act. SIPC is also a membership corporation. Members have to be registered with the SEC as brokers or dealers and be persons other than (i) persons whose principal business, in the determination of SIPC, is conducted outside the U.S. and (ii) persons whose business as a broker or dealer consists exclusively of:

- the distribution of shares of registered open-end investment companies or unit investment trusts;
- the sale of variable annuities;
- the business of insurance; or
- the business of rendering investment advisory services to registered investment companies or insurance company separate accounts.

SIPC has to file with the SEC a copy of any determination that its members are persons whose principal business is conducted outside the U.S., and the SEC affirms, reverses, or amends any such determination.

## **A2. The Board of Directors of SIPC**

SIPC has a Board of Directors consisting of the following seven persons, each appointed for a term of three years:

- One director appointed by the Secretary of the Treasury;
- One director appointed by the Federal Reserve Board;
- Five directors appointed by the President, by and with the advice and consent of the Senate as follows: (i) three directors associated with the securities industry, and (ii) two directors selected from the general public from among persons who are not associated with a broker or dealer or with a member of a national securities exchange.

For any changes in the bylaws of SIPC, the Board of Directors files with the SEC a copy of any proposed bylaw or proposed amendment to any bylaw. Each such proposed change takes effect thirty days after the date of the filing of a copy thereof with the SEC.

For any changes in the rules of SIPC, the Board of Directors of SIPC files with the SEC a copy of any proposed rule or amendment to any rule. The SEC publishes notice of such proposed rule change and gives interested persons an opportunity to submit written data in this respect. No proposed rule change can take effect unless approved by the SEC. The SEC will approve a proposed rule change if it finds that such proposed rule change is in the public interest.

The SEC may require SIPC to adopt or repeal any SIPC bylaw or rule whenever adopted.

## **B. The SIPC Fund**

### **B1. Establishment of the Fund**

SIPA established a SIPC Fund (the Fund) to which all amounts received by SIPC are deposited and from which all expenditures are made.

The balance of the fund consists at any time of the aggregate of:

- Cash on hand or on deposit;
- Amounts invested in U.S. Government or agency securities;
- Such confirmed lines of credit as SIPC may from time to time maintain. The amount of confirmed lines of credit is the aggregate amount which SIPC has the right to borrow from banks and other financial institutions under confirmed lines of credit or other written agreements which provide that moneys so borrowed are to be repayable by SIPC not less than one year from the time of such borrowings.

## **B2. Assessments**

### **Initial Assessments**

SIPC can impose by bylaw upon its members such assessments as it deems necessary to establish and maintain the Fund in an amount sufficient to pay SIPC's operating expenses, pay investors, and repay any borrowing. Any such assessment can be based upon (i) the amount of the members gross revenues from the securities business, or (ii) all or any of the following factors:

- the amount or composition of their gross revenues from the securities business;
- the number or dollar volume of transactions effected by them;
- the number of customer accounts maintained by them or the amounts of cash and securities in such accounts;
- their net capital, the nature of their activities and the consequent risks; or
- other relevant factors.

An assessment may be made at a rate in excess of 0.5 percent during any twelve month period, if SIPC determines that such rate of assessment during such period will not have a material adverse effect on the financial condition of its members, except that no assessments can be made which exceed in the aggregate 1 percent of such member's gross revenues from the securities business.

### **Requirements regarding assessments and lines of credit**

SIPC can impose upon each of its members an assessment at a rate not less than 0.5 percent per annum of the gross revenues from the securities business of such member (i) until the balance of the fund aggregates not less than \$150,000,000, or (ii) during any period when there is outstanding borrowing by SIPC, or (iii) whenever the balance of the fund is below \$100,000,000.

SIPC can make assessments in such a manner that the aggregate assessments payable by its members shall not be less than 0.25 percent per annum of the aggregate gross revenues from the securities business for such members during any period which the balance of the Fund aggregates less than \$150,000,000.

Since December 31, 1973, confirmed lines of credit cannot constitute more than \$50,000,000 of the balance of the Fund. When the balance of the Fund aggregates \$150,000,000, SIPC phases out of the Fund all confirmed lines of credit.

**Failure to pay assessments**

If a member fails to pay when due all or any part of an assessment made upon such member, the unpaid portion bears interest at a rate determined by SIPC, and in addition to such interest, SIPC may impose a penalty charge, which can not exceed 25 percent of any unpaid portion of the assessment. SIPC may waive such penalty charge if it considers such waiver appropriate.

**B3. Borrowing Authority**

SIPC has the power to borrow moneys and to evidence such borrowed moneys by the issuance of bonds, notes, or other evidences of indebtedness. The interest payable on a borrowing shall be equal to the interest payable on the related notes or other obligations issued by the SEC to the Secretary of the Treasury. To secure the payment of the principal of, and interest and premium, SIPC may make agreements with respect to the amount of future assessments to be made upon members and may pledge all or any part of the assets of SIPC and of the assessments made or to be made upon members.

**B4. SEC Loans to SIPC**

In the event that the Fund is or may reasonably appear to be insufficient, the SEC is authorized to make loans to SIPC. At the time of application, SIPC shall file with the SEC a statement with respect to the anticipated use of the proceeds of the loan. The SEC then issues notes or other obligations to the Secretary of Treasury (see below). If the SEC determines that the amount or time for payment of the assessments will not satisfactorily provide for the repayment of such loan, it may impose upon the purchasers of equity securities in transactions on national securities exchanges and in over-the-counter markets a transaction fee not exceeding one-fiftieth of 1 percent of the purchase price of the securities.

**B5. SEC Notes Issued to Treasury.**

The SEC is authorized to issue to the Secretary of the Treasury notes or other obligations in an aggregate amount not to exceed \$1,000,000,000 and which shall bear interest at a rate determined by the Secretary of the Treasury taking into consideration the current average market yield on outstanding marketable obligations of the U.S. of comparable maturities.

**C. Protection of Consumers**

If the SEC or any SRO believes that any broker or dealer is in or is approaching financial difficulty, it must immediately notify SIPC.

If SIPC determines that any member of SIPC has failed or is in danger of failing to meet its obligations to customers and one or more conditions listed under the following section exists, then SIPC files an application for a protective decree with any court of competent jurisdiction.

## **C1. Court Action**

Upon receipt of an application by SIPC, the court issues a protective decree either if the debtor consents, fails to contest such application, or if the court finds that such debtor: (i) is insolvent or is unable to meet its obligations as they mature, or (ii) is the subject of a proceeding pending in any court in which a receiver, trustee or liquidator for such debtor has been appointed, or (iii) is not in compliance with applicable requirements under the Securities Exchange Act of 1934 (the “Exchange Act”) regarding net capital, protection of customers’ funds and securities or hypothecation of customers’ securities, or (iv) is unable to make such computation as may be necessary to establish compliance with such net capital, protection of customers’ funds and securities, or hypothecation rules.

If the court issues a protective decree, it must appoint, as trustee for the liquidation of the business of the debtor and as attorney for the trustee, such persons as SIPC in its sole discretion specifies. SIPC may in its sole discretion, specify itself as trustee in any case in which SIPC has determined that the liabilities of the debtor to unsecured general creditors and to subordinated lenders appear to aggregate less than \$750,000 and that there appear to be fewer than 500 customers of such debtor.

The court grants reasonable compensation for services rendered and reimbursement for proper costs and expenses incurred by a trustee and by the attorney for such trustee in connection with a liquidation proceeding but no allowances can be granted to SIPC or any employee of SIPC for serving as trustee.

## **C2. Participation of the SEC and of SIPC**

The SEC may on its own motion file notice of its appearance in any proceeding under SIPA and may thereafter participate as a party. Also, SIPC is deemed to be a party in interest as to all matters arising in a liquidation proceeding, with the right to be heard on all such matters.

## **D. Provisions of a Liquidation Proceeding**

The purposes of a liquidation proceeding are, as promptly as possible after the appointment of a trustee, to: (i) deliver the customers of the debtor entitled thereto securities of the customer held by the broker and to distribute customer property and otherwise satisfy net equity claims of customers,<sup>†</sup> (ii) sell or transfer offices and other productive units of the business of the debtor, (iii) enforce rights of subrogation, (iv) liquidate the business of the debtor.

A liquidation proceeding is conducted in accordance with, and as though it were being conducted under chapters 1, 3, and 5 and subchapters I and II of the U.S. Bankruptcy Code.

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<sup>†</sup> Net equity claims are the claims of customers for money and securities held by the broker less any indebtedness of the customer to the broker for money or delivery of securities. Customer securities held by the broker but not available for return to the customer are valued at the date the SIPC trustee was appointed.

All costs and expenses of administration of the estate of the debtor and of the liquidation proceeding are borne by the general estate of the debtor to the extent it is sufficient. All funds advanced by SIPC to a trustee for such costs and expenses of administration are recouped from the general estate under section 507(a)(1) of the Bankruptcy Code.

## **D1. Powers and Duties of a Trustee**

### **Powers and duties**

A trustee is vested with the same powers and title with respect to the debtor and the property of the debtor, as a trustee in a case under the Bankruptcy Code. Furthermore, the trustee delivers securities to, or on behalf of customers, to the maximum extent practicable in satisfaction of customer claims for securities of the same class and series of an issuer. Subject to the prior approval of SIPC, but without any need for court approval, the trustee shall pay or guarantee all or any part of the indebtedness of the debtor to a bank, lender, or other person if the trustee determines that the aggregate market value of securities to be made available to the trustee upon the payment or guarantee of such indebtedness does not appear to be less than the total amount of such payment or guarantee.

The trustee makes such written reports to the court and to SIPC as may be required of a trustee in a case under Chapter 7 of the Bankruptcy Code.

### **Investigations**

The trustee (i) investigates the acts, conduct, property, liabilities and financial condition of the debtor and reports the results to the court and SIPC, (ii) examines, by deposition or otherwise, the directors and officers of the debtor, and (iii) reports to the court any facts ascertained by the trustee with respect to fraud, misconduct, mismanagement, and irregularities, and any causes of action available to the estate.

## **D2. Special Provisions of a Liquidation Proceeding**

### **Notice of proceedings**

The trustee must publish notice of the commencement of proceedings in one or more newspapers and mail a copy of such notice to each person who, from the book and records of the debtor, appears to have been a customer of the debtor with an open account within the past twelve months.

A customer can file with the trustee a written statement of claim but does not need to file a formal proof of claim, except that no obligation of the debtor to any beneficial owner of 5 percent or more of the voting stock of the debtor, or any member of the immediate family of any such person or owner may be satisfied without formal proof of claim.

Claims of a customer or other creditor of the debtor which are received by the trustee more than six months after the date of publication of notice cannot be allowed, except that the court may grant a reasonable, fixed extension of time for the filing of a claim by the U.S., by a State or political subdivision, or by an infant or incompetent person without a guardian. Any claim of such a customer for net equity which is received by the trustee after the expiration of such period of time

need not be paid or satisfied in whole or in part out of customer property, and, to the extent such claim is satisfied from moneys advanced by SIPC, it shall be satisfied in cash or securities as the trustee determines is most economical to the estate.

#### Payments to customers

After receipt of a written statement of claim, the trustee promptly discharges all obligations of the debtor to a customer relating to, or net equity claims based upon, securities or cash, by the delivery of securities or the making of payments insofar as such obligations are ascertainable from the books and records of the debtor or are otherwise established to the satisfaction of the trustee. All securities are valued as of the close of business on the filing date.

With respect to net equity claims, the court authorizes the trustee to satisfy claims out of moneys made available to the trustee by SIPC, and with respect to claims relating to, or net equities based upon, securities of a class and series of an issuer which are ascertainable from the books and records of the debtor or are otherwise established to the satisfaction of the trustee, the court authorizes the trustee to deliver securities of such class and series if and to the extent available to satisfy such claims in whole or in part.

#### Customer-related property

The trustee allocates customer property not identifiable or available for delivery to a specific customer as follows:

- First, to SIPC in repayment of advances made by SIPC to pay or guaranty debts of the member;
- Second, to customers of such debtor, who shall share ratably in such customer property on the basis and to the extent of their respective net equities;
- Third, to SIPC as subrogee for the claims of customers;
- Fourth, to SIPC in repayment of advances made by SIPC to purchase securities for delivery to customers.

Any customer property remaining after allocation becomes part of the general estate of the debtor. To the extent customer property and SIPC advances are not sufficient to satisfy in full the net equity claims of customers, such customers are entitled, to the extent only of their respective unsatisfied net equities, to participate in the general estate as unsecured creditors.

The trustee delivers customer name securities to on or behalf of a customer of the debtor entitled thereto if the customer is not indebted to the debtor.

Whenever customer property is not sufficient to pay the claims in full, the trustee may recover any property transferred by the debtor which, except for such transfer, would have been customer property if and to the extent that such transfer is voidable or void under the provisions of the Bankruptcy Code.



The trustee can purchase securities as necessary for the delivery of securities to customers in satisfaction of their claims for net equities based on securities and for the transfer of customer accounts, in order to restore the accounts of such customers as of the filing date. Customer property and moneys advanced by SIPC can be used by the trustee to pay for securities so purchased.

### Closeouts

Any contract of the debtor for the purchase or sale of securities in the ordinary course of its business with other brokers or dealers which is wholly executory on the filing date is not completed by the trustee, but is closed out by the counter-party.

A broker or dealer then nets all profits and losses on all contracts closed out and if such broker or dealer shows a net profit on such contracts, he then pays such net profit to the trustee and if such broker or dealer sustains a net loss on such contracts, he is entitled to file a claim against the debtor with the trustee in the amount of such net loss.

To the extent that a net loss sustained by a broker or dealer arises from contracts pursuant to which such broker or dealer was acting for its own customer, such broker or dealer is entitled to receive funds advanced by SIPC to the trustee in the amount of such loss, except that such broker or dealer may not receive more than \$40,000 for each separate customer with respect to whom it sustained a loss.

If a registered clearing agency by its rules has an established procedure for the closeout of open contracts between an insolvent broker or dealer and its participants, then it is not entitled to receive funds in payment of any losses on such contracts. Any funds or other property owed to the debtor, after the closeout of such contracts, must be promptly paid to the trustee.

### Transfer of customer accounts

The trustee may, subject to the prior approval of SIPC, sell or otherwise transfer to another member of SIPC, without consent of any customer, all or part of the account of a customer of the debtor. In connection with such sale or transfer, the trustee may waive or modify the need to file a written statement of claim and enter into such agreement as the trustee considers appropriate under the circumstances to indemnify any such member against shortages of cash or securities in the customer accounts sold or transferred.

## **E. SIPC Advances**

### **E1. Advances for Customer Claims**

SIPC advances to the trustee such moneys, not to exceed \$500,000, for each customer to pay claims for the amount by which the net equity of each customer exceeds his ratable share of customer property, with the following exceptions:

If all or any portion of the net equity claim of a customer in excess of his ratable share of customer property is a claim for cash, then the amount advanced to satisfy such claim for cash cannot exceed \$100,000 for each such customer.

If all or any portion of the net equity claim of a customer in excess of his ratable share of customer property is satisfied by the delivery of securities purchased by the trustee, then the securities so purchased are valued as of the filing date for purposes of applying the \$500,000 limitation.

No advance can be made to pay any net equity claim of a customer who is a general partner, officer, or director of the debtor, a beneficial owner of 5% or more of any class of equity security of the debtor, a limited partner with a participation of 5% or more in the net assets or net profits of the debtor, or a person who exercised a controlling influence over the management or policies of the debtor.

No advance can be made by SIPC to pay any net equity claim of any customer who is a broker or dealer or bank unless it is established that the net equity claim arose out of transactions for customers of such broker or dealer or bank, in which event each such customer is deemed a separate customer of the debtor.

## **E2. Other Advances**

SIPC advances to the trustee, to the extent the general estate of the debtor is not sufficient to pay any and all costs and expenses of administration of the estate of the debtor, the amount of such costs and expenses. SIPC may also advance to the trustee such moneys as may be required to pay or guarantee indebtedness of the debtor to a bank or lender to guarantee or to secure any indemnity or purchase securities.

## **F. Direct Payment Procedure**

### **F1. Notice**

If SIPC makes certain determinations, including that any of its members has failed or is in danger of failing to meet its obligations to customers, or that the claims of all customers of the member aggregate less than \$250,000, or that the cost to SIPC of satisfying customer claims will be less than the cost under a liquidation proceeding, then it may use the direct payment procedure set forth below.

SIPC causes notice of the such direct payment procedure to be published and, at the same time, mails a copy of such notice to each person who appears to have been a customer of the member with an open account within the past twelve months. Such notice states that SIPC will satisfy customer claims directly and sets forth the manner in which claims may be presented.

### **F2. Payments**

No claim by a customer is paid unless received within the six-month period beginning on the date of notice. SIPC may, for cause, grant a reasonable, fixed extension of time for the filing of a claim by the U.S., by a State or political subdivision thereof, or by an infant or incompetent person without a guardian.

SIPC promptly satisfies all obligations of the member to each of its customers insofar as such obligations are ascertainable from the books and records of the member or are otherwise established to the satisfaction of SIPC.

Any person aggrieved by any determination of SIPC with respect to his claim may within six months following mailing by SIPC of its determination with respect to such claim, seek a final adjudication of such claim. The courts having jurisdiction over cases under the Bankruptcy Code have original and exclusive jurisdiction in this respect.

If SIPC determines that continuation of such direct payment procedure is not appropriate, SIPC may cease such direct payment procedure and seek a protective decree as described above.

## **G. Functions of the SEC and SROs**

### **G1. Functions of the SEC**

In the event SIPC refuses to commit its funds or to act for the protection of customers of any member of SIPC, the SEC may apply to the district court of the U.S. for an order requiring the SIPC to discharge its obligations.

The SEC may make such examinations and inspections of SIPC and require SIPC to furnish it with such reports and records as it may deem appropriate.

After the close of each fiscal year, SIPC must submit to the SEC a written report relative to the conduct of its business, which includes financial statements setting forth the financial position of SIPC at the end of such fiscal year and the results of its operations. The financial statements are examined by an independent public accountant selected by SIPC and satisfactory to the SEC. The SEC transmits such report to the President and the Congress with such comments that it deems appropriate.

### **G2. Functions of SROs**

Each SRO acts as collection agent for SIPC to collect the assessments payable by all members of SIPC.

The SRO of which a broker-dealer is a member inspects or examines such member for compliance with applicable financial responsibility rules. The SROs file with SIPC such reports of inspections or examinations of the members as may be designated by SIPC by bylaw or rule.

SIPC consults and cooperates with the SROs in order to (i) develop and carry into effect procedures reasonably designed to detect approaching financial difficulty of a member, (ii) make sure examinations of the members by the SROs are conducted under appropriate standards and that the reports will be standard in form, and (iii) assure that each member of SIPC files financial information with the SRO which is the examining authority for such member.

The SEC may require any SRO to furnish SIPC with reports and records relating to the financial condition of its members.

Each member of SIPC must file such information (including reports of, and information with respect to, the gross revenues from the securities business of such member, including the composition thereof, transactions in securities effected by such member, and other information with respect to such member's activities, whether in the securities business or otherwise, including

customer accounts maintained, net capital employed, and activities conducted) as SIPC may determine to be necessary.

## **H. Prohibited Acts**

### **H1. Failure to Pay the Assessments**

If a member of SIPC fails to file any required report or information or fails to pay when due all or any part of an assessment and such failure is not cured within five days after receipt by such member of written notice, then it will be unlawful for such member, unless specifically authorized by the SEC, to engage in business as a broker or dealer. If such member denies that it owes all or part of the amount, it may after payment of the full amount so specified commence an action against SIPC in the appropriate U.S. district court.

### **H2. Engaging in Business after Appointment of Trustee or Initiation of Direct Payment Procedure**

It is unlawful for any broker or dealer for whom a trustee has been appointed to engage thereafter in business as a broker or dealer, unless the SEC otherwise determines in the public interest. The SEC may by order bar or suspend for any period, any officer, director, general partner, owner of 10% or more of the voting securities, or controlling person of any broker or dealer for whom a trustee has been appointed, if after appropriate notice and opportunity for hearing, the SEC determines such bar or suspension to be in the public interest.

### **H3. Concealment of Assets, False Statements or Claims**

Any person who, directly or indirectly, in connection with any liquidation proceeding or direct payment procedure:

- Employs of any device, scheme, or artifice to defraud;
- Engages in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person; or
- Fraudulently: (i) conceals or transfers of any property belonging to the estate of the debtor (ii) makes a false statement or account, (iii) presents or uses any false claim for proof against the estate of the debtor, (iv) receives any material amount of property from a debtor, (v) gives, offers, receives, or obtains any sort of compensation for acting or forbearing to act, (vi) conceals or falsifies any document relating to the debtor, and (vii) withholds from any person any document relating to the debtor,

will be fined up to \$50,000 or imprisoned for up to five years or both.

Any person who, directly or indirectly steals, embezzles, or fraudulently abstracts or converts to his own use any of the moneys, securities or other assets of SIPC can be fined \$50,000, imprisoned for up to five years, or both.

## **I. Miscellaneous Provisions**

### **I1. Public Availability of Documents**

Any notice, report, or other document filed with SIPC is available for public inspection unless SIPC or the SEC determines that disclosure thereof is not in the public interest.

### **I2. Liabilities**

No member can be liable as a member of SIPC for, or in connection with, any act or omission of any other broker or dealer not controlled by such member in connection with the conduct of the business of such broker or dealer, and no member shall have any liability for or in respect of any indebtedness or other liability of SIPC.

Neither SIPC nor any of its Directors, officers, or employees shall have any liability to any person for any action taken or omitted in good faith.

## APPENDIX B

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### **The United Kingdom's Investors Compensation Scheme**

The Investors Compensation Scheme (ICS) was set up in the U.K. in 1988 as a rescue fund for clients of authorized investment firms that have gone out of business. The rules governing the ICS were set up pursuant to the Financial Services Act of 1986.

#### **A. The Investors Compensation Scheme (ICS)<sup>‡</sup>**

##### **A1. Investment Regulators of the ICS**

The following entities, called investment regulators, supervise and control their members, which are firms providing investment services called "authorized investment firms":

- The Financial Services Authority (FSA), formerly the Securities and Investment Board, is the senior regulator and is responsible for supervising the investment regulators and acts for some authorized investment firms.
- The Investment Management Regulatory Organization (IMRO)
- The Personal Investment Authority (PIA)
- The Securities and Futures Authority (SFA)

The ICS operates under the rules of the FSA. Pursuant to such rules, the ICS covers two types of losses: (i) losses incurred when an authorized investment firm goes out of business and cannot return an investment, or (ii) losses incurred from bad investment advice or poor investment management. In both situations, the ICS only gets involved when the investment firm is no longer in business and has no funds to pay investor's claims.

The ICS is funded by a levy paid by the investment firms to the FSA, IMRO, PIA, and SFA. These entities are responsible for allocating the levy to their authorized firms and for putting in place efficient collection procedures. In 1997, forward funding was introduced, enabling the ICS to include in its levy the estimated amounts to be paid to investors in the forthcoming 12 months.

##### **A2. The Board of Directors of the ICS**

The Board of Directors, chaired by an independent Chairman, comprises eleven directors. The FSA appoints the Chairman and five public interest directors. The PIA appoints two directors, and the IMRO and the SFA appoint one director each. The Board of Directors itself appoints the Chief Executive, who is the eleventh director.

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<sup>‡</sup> The Financial Services Market Act 2000 combines the ICS with insurance protection funds for banks, building and loans, life insurance companies and others. Implementing regulations have not been adopted. Therefore, we have limited our discussion to the existing ICS regulations.

## **B. Claim Procedures**

### **B1. Initiating a Claim**

The customer of the investment firm writes to the ICS and states the name and address of the authorized investment firm, the amounts invested, the type of investment, and the reasons for a claim.

### **B2. The ICS's Investigation**

The ICS investigates the firm and ascertains that the firm is “in default.” A firm cannot be declared in default if it could deliver the money or investments it owes or pay for losses it might have caused, but refuses to do so.

When the ICS declares a firm in default, it automatically sends a claim form to the firm's customers it believes may have losses or who have written to the ICS in this respect. The claim forms must be returned to the ICS within six months of their receipt by the investor.

The ICS only handles claims involving a problem that started within the past six years, subject to specific exceptions. Furthermore, the ICS can only pay compensation for bad advice or poor investment management by an authorized investment firm if the bad advice or the poor investment management took place after the latter of: (i) August 28, 1988, the date on which the ICS was established, or (ii) after the firm became authorized by one of the regulators.

### **B3. The Complaints Procedure**

If an investor is dissatisfied with the ICS' response, there is a complaint procedure to handle the investor's complaint. First, it is reviewed by a panel of non-executive directors, and for a further and final investigation, by the ICS' Independent Investigator, at the Board's discretion.

## **C. Types of Investments Covered by the ICS**

The FSA has set up specific rules defining the type of losses that can be compensated. The following investments are covered: (i) stocks and shares, (ii) unit trusts, (iii) futures and options, (iv) personal pension plans, and (v) some long-term insurance policies, such as endowments.

Bank and building society accounts and claims against insurance companies have their own compensation arrangements. There are no compensation arrangements covering investments in coins, livestock, or antiques. The ICS does not cover foreign investment firms that are not authorized by one of the investment regulators in the U.K.

Authorized investment firms, such as stockbrokers, may arrange for customers' shares to be registered in the name of a nominee company. Nominee companies will be covered if an authorized investment firm has accepted responsibility for their losses.

## **D. Payment of Compensation**

If the ICS accepts the claim, it will pay the first £30,000 of the claim in full, and 90 percent of the next £20,000. Therefore, the ICS can only pay up to £48,000 to a customer of each firm declared

in default. If the customer has made a joint investment, then the ICS can pay both the customer and his partner up to £48,000 each.

### **E. Recoveries of the Compensation Costs by the ICS**

The ICS seeks recovery of the costs of compensation paid to investors either from the firm in default or from third parties that may have some responsibility for the investors' losses. On payment of compensation, investors assign to the ICS rights of action in respect of their claims. Such recoveries are usually very limited or non-existent.

Other sources of recovery are available to the ICS, including distributions from liquidators and trustees, actions against third parties, and claims under the defaulted firm's professional indemnity insurance. The ICS is entitled to retain recoveries up to the total of compensation paid, plus interests and costs. However, in a few cases, the ICS rules provide that it must distribute recoveries to investors where those investors have been disadvantaged by accepting the offer of compensation, for example, before the final distribution has been made by a liquidator.

### **F. The European Commission Investor Compensation Directive (ICD)**

Pursuant to the ICD, all member states of the European Economic Area (EEA) must have an investor compensation scheme for firms who are authorized in their own country to carry on certain types of investment business.

Under the ICD, investors are covered for losses or assets to at least 90 percent of the value of the claim, up to €20,000.

The ICD does not provide for coverage of losses due to negligent advice. Also, long-term insurance contracts, including pensions and endowments, are not covered by the ICD.

Investors doing business with a U.K. branch of an EEA investment firm will be covered by that country's home state compensation scheme.





## **APPENDIX C**

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### **The Canadian Investor Protection Fund**

The Canadian Investor Protection Fund (CIPF), which prior to 1990 was called the National Contingency Fund, was established in 1969 by an Agreement and Declaration of Trust. The CIPF protects customers in the event of insolvency of a member. Also, the CIPF oversees the self-regulatory system. The “Members” of the CIPF are the Canadian brokers and dealers.

#### **A. The Canadian Investor Protection Fund**

##### **A1. The Sponsoring Self-Regulatory Organizations (SROs)**

The following SROs are parties to the CIPF:

- The Toronto Stock Exchange
- The Montreal Exchange
- The Canadian Venture Exchange<sup>§</sup>
- The Winnipeg Stock Exchange
- The Investment Dealers Association of Canada

In addition to continuous review of the Member's financial condition by the CIPF and the SROs, the CIPF oversees the self-regulatory system through: (i) an early warning system comprised of monthly and annual financial and operational reports from the Members, (ii) periodic surprise visits to the offices of a Member by the examination staff of an SRO to confirm full compliance with the CIPF's national standards, (iii) an annual audit and report by a public accounting firm, (iv) the requirement that customers' fully paid securities and excess margin securities be segregated from all other securities held by the Member, (v) the requirement that Members meet the capital and liquidity standards established by the CIPF, and (vi) disciplinary penalties and sanctions against Members which violate the requirements of the SROs.

##### **A2. Administration of the CIPF**

The CIPF is administered by a Board of twelve governors. Five of the governors are representatives of the SROs and five of the governors represent the investing public. The Chairman, President, and the Chief Executive Officer of the CIPF are also governors.

The Board of Governors can exercise its discretion in respect of determining customers eligible for protection and the amount of financial loss suffered in a manner that is consistent with the right and extent to which a person may be entitled to claim against the customer pool fund of a Member under the Canadian Bankruptcy and Insolvency Act. Persons who deal with CIPF Members through accounts used for business financing purposes such as securities lending and purchase/repurchase transactions are not eligible for CIPF protection in respect of such accounts.

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<sup>§</sup> The Canadian Venture Exchange was created late last year by the merger of the Alberta Stock Exchange and the Vancouver Stock Exchange. Both of these exchanges were original members of the CIPF.

**A3. Customers**

A customer can be an individual, a corporation, a partnership, an unincorporated syndicate, an unincorporated organization, a trust, a trustee, an executor, an administrator, or other legal representative, but cannot include:

- A Member of a sponsoring SRO
- Any individual who has a claim for cash or securities which by contract is part of the capital of the insolvent Member such that the claim represents 5 percent or more of any class of security of the insolvent Member
- A general partner or director of the insolvent Member
- A limited partner with a participation of 5 percent or more in the net assets or net profits of the insolvent Member
- A clearing corporation
- A customer of an institution, securities dealer, or other party dealing with a Member of an SRO on an omnibus basis
- A customer who caused or materially contributed to the insolvency of a Member.

**B. Funding of the CIPF**

The assets of the CIPF include contributions by the securities industry through: (i) assessments collected by the SROs of Members and the net income earned thereon, (ii) risk premiums based on capital deficiencies, and (iii) an annual contribution by the SROs of the interest allocated to them in the prior year. The CIPF also has a CAD\$50,000,000 line of credit provided by a Canadian chartered bank. The aggregate of all assessments in a calendar year may generally not exceed 1 percent of the aggregate gross revenues of all CIPF Members in that year.

**C. Accounts Covered**

Accounts of a customer such as cash, margin, stock, options, futures, and foreign currency are combined and treated as one general account entitled to the maximum coverage.

Accounts eligible for CIPF coverage carried by a Member for a customer which are introduced by different SRO Members are treated as separate accounts. Eligible accounts carried by a Member for a customer which are introduced by the same SRO Member are combined and aggregated as a simple general account, unless the accounts otherwise qualify as separate accounts. The burden is on the customer to establish each capacity or circumstance in which the customer claims to hold separate accounts.

## **D. Claims**

### **D1. Submission of Claims**

Customers have 180 days to file a claim. The 180-days period commences on (but excludes) the date of bankruptcy, if applicable, or the date of insolvency as determined and communicated by the CIPF or the trustee in bankruptcy/receiver. Claims are generally made directly to the trustee in bankruptcy or the receiver. The CIPF may rely on the trustee in determining the amount and validity of claims of a customer for purposes of calculating net equity. The CIPF may require the customer to provide additional information necessary to establish the amount and eligibility of a claim for CIPF coverage. If a claim is rejected by CIPF, an appeal may be made to the Board of Governors.

The trustee/receiver must determine the total of customer's claims and the quantity of securities, cash, and other property available to meet such claims before a distribution can commence.

### **D2. Determination of the Amount of a Claim**

The trustee in bankruptcy or the CIPF determines the customer's net equity in each of the customer's accounts. The net equity in an account is the total value of cash, securities, and other eligible property owed to the customer by the insolvent Member less the value of cash, securities, and property owed by the customer to the insolvent Member. The customer's claim to the CIPF for net equity is determined after deducting any free credit balances (cash), securities, and other eligible property that has been returned to the customer following the date of bankruptcy or insolvency, as the case may be, in accordance with the provisions of the Bankruptcy and Insolvency Act.

Claims are valued at the date of bankruptcy of the Member, if applicable, or the date of the insolvency of the Member as determined by the CIPF. The CIPF may deliver to the customer securities which are the subject of the claim or may instead satisfy the claim for securities by cash based on the value of the securities (in Canadian dollars) at the date of bankruptcy and not the date of payment.

## **E. Payments**

The Board of Governors may authorize payments to be made to each customer considered eligible for protection by the CIPF who has suffered financial loss to a maximum amount of CAD\$1,000,000 (including claims for cash). The amount of a customer's claim for cash will be reduced to the extent that the customer is entitled to deposit insurance in respect of all or any of the cash held for an account or to compensation in respect of other securities or property.